

## **FINANCIAL MANAGEMENT**

### **Define the term Financial Management.**

J.F. Bradley defines financial management as, "The area of the business management devoted to a judicious use of capital and a careful selection of sources of capital in order to enable a spending unit to move in the direction of reaching its goals."

### **What do you understand by business finance?**

Business finance is that business activity which is concerned with the acquisition and conservation of capital funds in meeting financial needs and overall objectives of a business enterprise.

### **What is the scope of financial management?**

The main objective of financial management is to arrange sufficient finances for meeting short – term and long term needs. These funds should be procured at minimum costs so that profitability of the business is maximised. With these things in mind, a financial manager will have to concentrate on the following areas of finance function. Hence the scope of financial management includes :

- i. Estimating Financial Requirements
- ii. Deciding Capital Structure
- iii. Selecting a Source of Finance
- iv. Selecting a Pattern of Investment
- v. Proper Cash Management
- vi. Implementing Financial Controls
- vii. Proper use of Surpluses.

### **What are the Functions of Finance?**

The functions of financial management are 4 as given below:

#### **(i) Investment Decision :**

Investment decisions or capital budgeting decisions refers to a firm's decision to invest its current funds in long-term assets in anticipation of a series of returns in future. Every capital budgeting decisions has two aspects one : an outflow of cash and another an outflow of funds. Hence an important aspect of this is the decision is measuring future profitability of new investment.

It is to be noted before a comparison can be made between the cash inflows and cash outflows they have to be brought to a common plane – i.e., today. Hence with an appropriate discount rate called the cost of capital we have to first find out the present value of the future stream of cash inflows.

Cost of capital can be defined as the cost associated with borrowings made by a firm However, one confronts many problems in computing the cost of capital in practice.

Also another aspect is that it is impossible to predict the future cash inflows with certainty. Investment proposals should, therefore, be evaluated in terms of both *expected return and risk*.

#### **(ii) Financing Decision :**

Financing decision would involve deciding when, where and how to acquire funds to meet the firm's investment needs. The central issue before the Finance Manager is to determine the proportion of equity and debt. The mix of debt and equity is known as the firm's *capital structure*. Capital structure refers to the make up of a firm's total capitalization. In other words it refers to the various long term sources of funds.

The financial manager must strive to obtain the best financing mix or the *optimum capital structure* for his firm. The firm's capital structure is considered to be optimum when the overall cost of capital is at its minimum and the market value of shares is maximised. The use of debt helps in increasing the Earnings Per Share which in turn helps in increasing the Dividend Per Share which in turn helps to increase the Market Price Per Share.

Once the financial manager is able to determine the ideal or best combination of debt and equity, he must raise the appropriate amounts through best available sources. In practice, a firm considers many other factors such as control, flexibility, loan covenants, legal aspects, etc. in deciding its capital structure.

### **(iii) Dividend Decision :**

This is the third major financial decision. The financial manager must decide whether the firm should distribute all profits, or retain them, or distribute a portion and retain the balance. Like the debt policy, the dividend policy should be determined in terms of its impact on Market Price Per Share which would help in increasing the wealth of equity shareholders.

The optimum dividend policy is one which maximises the market value of the firm's shares. Thus, if the shareholders are interested in receiving dividend, the financial manager must determine the *optimum dividend payout ratio*.

The dividend payout ratio is equal to the percentage of dividends distributed to earnings available to shareholders. The financial manager should also consider the question of dividend stability, bonus shares and cash dividend in practice. Most profitable companies pay cash dividends regularly. Periodically additional shares, called bonus shares are also issued to the existing shareholders in addition to the cash dividend.

### **(iv) Liquidity Decision :**

Current assets management which affects a firm's liquidity is yet another important finance function, in addition to the management of long-term assets. Current assets should be managed efficiently for safeguarding the firms against the dangers of illiquidity and insolvency. Investment in current assets affects firm's profitability, liquidity and risk.

A conflict exists between profitability and liquidity while managing current assets. If the firm does not invest sufficient funds in current assets, it may become illiquid. But it would lose profitability as idle current assets would not earn anything. Thus a proper trade-off must be achieved between profitability and liquidity.

In order to ensure that neither insufficient nor unnecessary funds are invested in current assets, the financial manager should develop sound techniques of managing current assets and make sure that funds would be made available when needed.

### **Define Capital Structure**

Capital structure refers to the make-up of a firm's total capitalisation. In short it refers to the various long term sources of funds such as :

- i. Equity share capital
- ii. Preference share capital and
- iii. Debt which included debenture, bonds and long-term loans

In other words it represents the mix of different sources of long-term funds such as equity shares, preference shares, debt and retained earnings.

### **Capital structure and financial structure**

The term capital structure differs from financial structure. Financial structure refers to the way the firm's assets are financed. In other words, it includes both long term as well as short-term sources of funds. Capital structure is the permanent financing of the company represented primarily by long-term funds such as equity, preference and debt. It excludes all short-term credit. Thus a company's capital structure is only a part of its financial structure.

### **Patterns of capital structure**

In case of new company the capital structure may be of any of the following four patterns:

- Capital structure with equity shares only
- Capital structure with both equity and preference shares
- Capital structure with equity shares and debt and
- Capital structure with equity shares, preference shares and debentures.

### **Trading on Equity**

Trading on equity refers to the inclusion of fixed return bearing securities (like debt and preference share capital) in the capital structure so as to increase the EPS which in turn would lead to an increase in DPS and thereby bring about an increase in the market price of the share and the value of the firm. Thus the company resorts to trading on equity with the objective of giving the equity share holders a higher rate of return to compensate them for the risk they have to bear.

### **Indifference Point**

It refers to that level of EBIT at which EPS remains the same irrespective of the capital structure or debt-equity mix.

## CAPITAL BUDGETING DECISIONS

A capital budgeting decision may be defined as the firm's decision to invest its current funds most efficiently in long term assets in anticipation of an expected flow of benefits over a series of years.

### Types of investment decisions :

There are many ways to classify investments. One classification is as follows :

- a. Expansion of existing business
- b. Expansion of new business
- c. Replacement and modernization

Yet another useful way to classify investments is as follows:

- a. Mutually exclusive investments
- b. Independent investments
- c. Contingent investments

### Evaluation Criteria:

A number of investment criteria (or capital budgeting techniques) are in use in practice. They may be grouped in the following two categories :

#### I. Non-discounted Cash Flow Techniques / Traditional Methods

- i. Payback period (PB)
- ii. Accounting Rate of return (ARR)

#### II. Discounted Cash Flow Technique

- i. Net Present value (NPV)
- ii. Internal Rate of return (IRR)
- iii. Profitability index (PI)
- iv. Discounted Payback period

### I. Non-Discounted Cash Flow Criteria

#### Payback period

**Payback (PB)** is the number of years required to recoup the initial cash outlay of an investment project. The project would be accepted if its payback is less than the standard payback. The greatest limitations of this method are that it does not consider the time value of money, and does not consider cash flows after the payback period.

#### Acceptance rule

- Accept if PB < standard payback
- Reject if PB > standard payback

#### Merits

- Easy to understand and compute and inexpensive to use
- Emphasizes liquidity.
- Easy and crude way to cope with risk. .
- Uses cash flows information.

### **Demerits**

- Ignores the time value of money.
- Ignores cash flows occurring after the payback period.
- Not a measure of profitability
- No objective way to determine the standard payback.
- No relation with the wealth maximization principle

### **Accounting Rate of Return**

Accounting rate of return indicates the average rate of return expected from a project or investment. It is found out by dividing the average profit after-tax by the average amount of investment. A project is accepted if its ARR is greater than a cut off rate (arbitrarily selected). This method is based on accounting flows rather than cash flows; therefore, it does not account for the time value of money. Like PB, it is also not consistent with the objective of the shareholders' wealth maximisation.

#### **Acceptance rule :**

- Accept if  $ARR >$  minimum rate
- Reject if  $ARR <$  minimum rate

### **Merits**

- Uses accounting data with which executives are familiar
- Easy to understand and calculate.
- Gives more weightage to future receipts.

### **Demerits**

- Ignores the time value of money
- Does not use cash flows.
- No objective way to determine the minimum acceptable rate of return.

### **NET PRESENT VALUE METHOD**

The net present value method is the best method of evaluating the investment proposals. It is a DCF technique that explicitly recognizes the time value of money. It believes that cash flows arising at different time periods differ and are comparable only when their equivalents – present values are found out.

NPV is the difference between PV of cash flows and the PV of cash outflows is equal to NPV; the firm's opportunity cost of capital being the discount rate.

- The project should be accepted if NPV is positive (i.e.,  $NPV > 0$ ).
- Net present value should be found out by subtracting present value of cash outflows from present value of cash inflows. The formula for the net present value can be written as follows:

Net present value should be found out by subtracting present value of cash outflows from present value of cash inflows.

#### **Acceptance rule :**

- Accept if  $NPV > 0$  (i.e., NPV is positive)
- Reject if  $NPV < 0$  (i.e., NPV is negative)
- Project may be accepted if  $NPV = 0$

#### **Merits :**

- Considers all cash flows.
- True measure of profitability.
- Based on the concept of the time value of money
- Satisfies the value-additivity principle (i.e., NPV's of two or more projects can be added).
- Consistent with the share-holders' wealth maximization (SWM) principle.

#### **Demerits :**

- Requires estimates of cash flows which is a tedious task
- Requires computation of the cost of capital which poses practical difficulties.
- Sensitive to discount rates used to calculate the present value of cash flows.

## **INTERNAL RATE OF RETURN**

Internal Rate of Return (IRR) is that discount rate at which the project's net present value is zero. IRR is denoted by as ' $r$ '. Under the IRR rule, the project will be accepted when its internal rate of return is higher than the cost of capital ( $r>k$ ). IRR methods account for the time value of money and are generally consistent with the wealth maximization objective.

#### **Acceptance rule :**

- Accept if  $IRR >k$
- Reject if  $IRR <k$
- Project may be accepted if  $IRR = k$

#### **Merits:**

- Considers all cash flows..
- True measure of profitability.
- Based on the concept of the time value of money
- Generally, consistent with wealth maximization principle.

#### **Demerits:**

- Requires estimates of cash flows which is a tedious task
- Does not hold the value-additivity principle (i.e., IRRs of two or more projects do not add)
- At times fails to indicate correct choice between mutually exclusive projects.
- At times yields multiple rates when there is more than one change in cash flows.
- Relatively difficult to compute as it has to be calculated b.

## **PROFITABILITY INDEX**

Profitability index (PI) is the ratio of the present value of cash inflows to initial cash outlay. It is a variation of the NPV rule. PI specifies that the project should be accepted when it has a profitability index greater than one ( $PI > 1.0$ ) since this implies a positive NPV.

### **Acceptance rule :**

- Accept if  $PI > 1.0$
- Reject if  $PI < 1.0$
- Project may be accepted if  $PI = 1.0$

### **Merits**

- Considers all cash flows.
- Recognizes the time value of
- Relative measure of profitability.
- Generally consistent with the wealth maximisation principle.

### **Demerits**

- Requires estimates of the cash flows which is a tedious task.
- At times fails to indicate correct choice between mutually exclusive projects.

### **Discounted Payback**

Discounted Payback considers the time value of money, but like the simple payback it also ignores cash flows after the payback period. Under the conditions of constant cash flows and a long life of the project, the reciprocal of payback can be a good approximation of the project's rate of return.

**Net present value (NPV) method is the most superior investment criterion as it is always consistent with the wealth maximisation principle.**